JPMorgan

INVESTOR SERVICES: The Consultants' View

Plan sponsors face a whole new set of challenges in this uncertain investment environment and, if there is one certainty, it is the increasingly complex nature of the decisions with which they are faced. Against that backdrop, plan sponsors increasingly have turned to their consultants to help them understand which products and approaches make the most sense for their own particular needs and circumstances.

Consultants have become increasingly involved in custody, securities lending, and investor-service related searches. JPMorgan Investor Services has, for a generation, been a leading player in the investor services industry, and we are committed to an information-sharing process that furthers the best interests of our institutional clients. With that in mind, we were pleased to be able to commission proprietary research in partnership with *PLANSPONSOR*, for the second year in a row, that shows how institutional investors are using their investment consultant relationships to better understand and utilize these new and traditional securities services offerings. In addition, JPMorgan Investor Services has sponsored a second annual roundtable with *PLANSPONSOR* with some of the leading consultants to discuss this research, as well as to air some of the challenges and opportunities now presenting themselves to institutional investors.

Ed Mollahan

PHOTOGRAPHY BY LAURA MOSS

From left: CRA RogersCasey's Tim Barron, Callan Associates' Bo Abesamis, Russell Investment Group's Greg Korte, Evaluation Associates' Ellen Petrino

The consultant community continues to shape what plan sponsors look for in their master trust relationships, and how they find the relationships that suit plan sponsors best. In September this year, JPMorgan Investor Services hosted a roundtable in New York with a group of industry leaders in the consultant community to discuss the evolution of investor services. The consultants included: Tim Barron, president and CEO of CRA RogersCasey, based in Darien, Connecticut; Bo Abesamis, senior vice president of San Francisco-based Callan Associates; Greg Korte, manager compliance and risk, investment operations, Russell Investment Group, based in Tacoma, Washington; Ellen Petrino, a senior consultant at Norwalk, Connecticut-based Evaluation Associates; and Ed Mollahan, senior vice president of JPMorgan Investor Services, based in New York.

PS: The investor services business is dominated now by a handful of master trust providers. Will we see further consolidation in the years ahead?

Abesamis: There has been consolidation and there's likely to be more. The next few years are very important for the industry—those banks unable to execute strategically and tactically this year and next year may well turn out to be casualties. That said, while there might be a contraction of major players, there will continue to be room for niche players who will be happy with a small piece of the pie. Full-service capabilities are still dominated by the majors.

Mollahan: Breadth of services now is increasingly in demand by most institutional clients, large and small. Mid-size corporate and public funds want a core set of capabilities delivered much the same way as larger plans.

Korte: I think there's room for further consolidation. The technology spend for the large institutions is so big now that only a few banks can afford to compete. We'll likely end up with a narrow range of very large, leveraged providers on one end, and then a handful of small, nimbler players on the other end. Even if the largest players are unlikely to be able to meet everyone's needs—there will always be room for specialist providers who perform very well.

Petrino: I have been reluctant to consider non-first tier players for searches, because it seems to be so important to choose a custodian that you know will stay in the business—you don't want to find yourself forced to do another search a couple of years later. As for consolidation, it likely will take place, if only as a function of continued general bank acquisitions.

Barron: You have a number of drivers at work here. First, the banking industry is generally consolidating. Second, there is the necessity of leveraging all this technology expenditure across as broad a client base as possible, which means that scale is vital. Then, there's complexity, too: Pension funds are investing in more and more complex instruments, and custodians are obliged to service them wherever they turn. The net of all this is that, even though we've seen tremendous consolidation among custodians in the past few years, we're likely to see more. There are pros and cons to that outcome. Certainly, from a sponsor's standpoint, the ability to access great technology at a relatively low price is a terrific thing but, at some point, the relatively few major providers could lead, at least in theory, to creating a pricing problem.

PS: As consultants, how do you look at unbundling when it comes to separating all the elements that go into a custody relationship today?

Pension funds are investing in more and more complex instruments, and custodians are obliged to service them wherever they turn.

Abesamis: When I look at a custody search these days, I consider it as a whole number of searches within a search. The fact is that—at least in theory—there are perhaps 28 or so specific products or services deployed by a custodian, and all 28 could be unbundled. There are pretty meaningful advantages to bundling, but there are enough interesting specialist players, particularly in areas like third-party securities lending and transition management, that also will ensure that bundling everything up into one relationship is not always the best way to go.

Mollahan: The way we look at it at JPMorgan Investor Services, we have to ensure that, whatever that product range is, we have to deliver a best-practice solution in every single one, otherwise there is a danger of unbundling. However, if you can demonstrate those best practices, you also can bring into play all the advantages of a single relationship for your institutional clients. That may include pricing, but it also includes a whole new level of access to information across a client's entire portfolio—and CFOs are beginning to understand exactly how valuable that sort of information can be.

Barron: To some extent, we look at unbundling as a good check and balance against the dominant players—if they overprice or under serve, they face the threat of having niche players take valuable slices of the business away from them. It appears that thus far the best custodians have shown themselves to be adept at maintaining their grip on the marketplace.

Korte: I think it's an issue of transparency—you need to understand what it is that you're getting in these services, and what you're paying for them. If several sources of revenue are not disclosed to the client, that can lead to inferior investment results.

Petrino: I think it also is worth stressing that many clients really only want one relationship in this area, and I'd prefer to give them one relationship. Wherever it makes sense, I'd like to avoid having multiple service providers.

PS: Securities lending has been mentioned a couple of times. Is that the exception to the bundling rule?

Abesamis: There has been a proliferation of third-party lenders, and some have the track records to show that they can bring value to the table. There is a whole variety of factors to consider in this regard, but the first barrier to clear is size: Unless you have a very large portfolio, it is probably not an option worth considering but, at the end of the day, all competition is good for clients—choice is good.

Korte: Regarding the point that Tim made earlier, I think third-party securities lenders are players who help keep the huge banks on their game. As noted, it is a function of size and also of asset makeup. Certain types of portfolios may make sense for third-party lending but, by and large, the large custodians seem to have been effective in ensuring that they keep their hold on these portfolios.

Petrino: I think the threat of unbundling has obliged the large custodians to really get their act together in the securities lending space: It seems to me that the most professional and best-run elements of the custodians are very often their securities lending operations.

Mollahan: From a provider's standpoint, it comes back to leveraging the strength of the bank. There are specific advantages that we like to point to: For instance, many third-party lenders don't have either the balance sheet to support things like indemnification, which often is required, or the broad range of borrower relationships. Also, at JPMorgan Investor Services, we have a risk-averse approach to securities lending, which has always resonated with clients. At the end of the day, however, our challenge is to show our clients that our scale really works to their advantage when it comes to lending their portfolios, and I think our track record in the space shows that we have been able to get that across very successfully.

PS: The custody banks have become much more focused on the transition management business in the last few years. How should plan sponsors view these ambitions?

Abesamis: This is a timely issue. Custodian banks with excellent infrastructure, particularly those with index management capabilities and the attendant crossing capability, certainly should be considered when doing a transition search. About one-third of a transition is about project management, and custodians are well-suited to that challenge. The

methodology

In August 2004, *PLANSPONSOR* solicited feedback from a broad range of plan sponsors as to how they use consultants for their retirement plan issues. Question topics ranged from the types of consulting services used and conflict of interest issues to fees and top-of-mind concerns. All responses were received exclusively via a 13-question, Web-based questionnaire. The survey was closed on September 10th with a total of 115 valid responses from plan sponsors of all sizes. For a copy of the full study results, please contact edward.mollahan@jpmorgan.com

Total plan assets

Less than $10MM	14.8%
$10MM-$49MM	19.1%
$50MM-$199MM	17.4%
$200MM-$499MM	13.9%
$500MM-$999MM	11.3%
More than $1 billion	23.5%

Fund type

Corporate/ERISA	66.1%
Public/Government	20.0%
Union	4.3%
Non-profit	3.5%
Hospital	2.6%
Endowment/Foundation, Other	3.4%

Do you currently use, or have you ever used, a consultant for any of the following services?

	2004	2003
Performance and analytics	86.1%	79.6%
Universe comparisons	67.0%	69.9%
Compliance monitoring	54.8%	39.8%
Performance attribution	48.7%	60.2%
Custodian selection/monitoring	33.9%	55.9%
	12.2%	18.3%

Nearly 90% of plan sponsors call on consultants to give them performance and analytics. By contrast, just 12% of plans use consultants for Value at Risk reporting.

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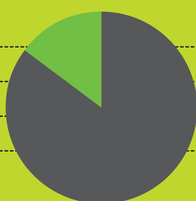
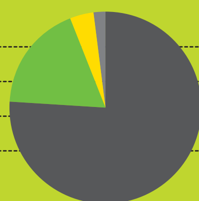


Consultants are not often retained by plan sponsors on a project basis.

How many consulting firms do you use?

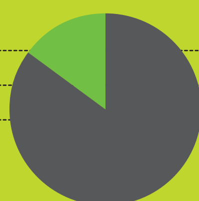
1	76%
2	18%
3	4%
4 or more	2%



Nearly 94% of the plans in this study use just one or two consultants.

How important is it to you that your consultant be free of conflicts of interest?

Extremely important – the consultant must be entirely free of conflicts	85.1%
Somewhat important – some conflicts are acceptable, as long as they are disclosed	14.9%
Not at all important – the consultant's conflicts of interest are not a concern to us	0.0%



An overwhelming 85% of plans insist that their consultant be free of conflicts of interest. Not one plan sponsor considers this issue unimportant.

What is more important to you in your consultant relationship?

	2004	2003
■ The relationship with the consulting firm	28.3%	32.9%
■ The relationship with the individual employee/consultant at the firm	71.7%	67.1%

Confirming 2003 data, the relationship with the individual consultant is more important to plans than the relationship with the consulting firm.

What are the most pressing issues you face as a plan sponsor?

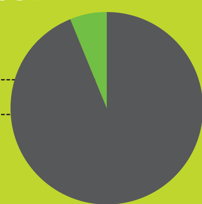
	Overall	Less than $200M	More than $200M
Maximizing investment returns	54.8%	45.8%	64.3%
Fiduciary responsibility/404(c) compliance	48.7%	66.1%	30.4%
Educating employees about their retirement benefits	48.6%	66.1%	30.4%
Investment manager or fund monitoring	43.5%	33.9%	53.6%
Managing risk in the portfolio	39.1%	30.5%	48.2%
Managing the funding level of the DB plan	33.9%	16.9%	51.8%
Regulatory issues	11.3%	13.6%	8.9%
Employee participation rates in the DC plan	11.3%	15.3%	7.1%

Maximizing investment returns is top of mind for plan sponsors overall, with more than half of the respondents citing this as a pressing issue. When analyzed by size of the plan, priorities differ. Smaller plans are more concerned with fiduciary issues and employee education, whereas larger plans see investment returns and manager oversight as a priority.

Do you feel the fees you pay are commensurate with the consultant's services?

■ Yes	93.8%
■ No	6.2%

A finding which should sit well with consultants, nearly all plan sponsors feel that the fees they pay are fair.



Who is your best resource for creative solutions in the following areas?

	Regulatory issues	Industry events	Best practices/ Peer benchmarking	New investment vehicles
■ **Consultant**	54.9%	62.2%	85.6%	77.9%
■ **Investment Manager**	1.8%	11.7%	3.6%	12.4%
■ **Broker/Dealer**	0%	2.7%	0%	1.8%
■ **Custodian**	15.0%	10.8%	6.3%	3.5%
■ **Other**	28.3%	12.6%	4.5%	4.4%

Consultants are the #1 resource turned to by plan sponsors for all of the issues listed.

process of finding the right transition manager is a complex one, however, not least because transitions are hard to benchmark, and there's no way to unwind a transition that doesn't work to your satisfaction.

Korte: At Russell, we are real believers that plan sponsors should consider a transition manager every time they undertake a transition. We are also leading efforts to try to establish uniform standards in this space. The issue whether custodians should serve as transition managers comes down to execution. It's up to the custodian banks to demonstrate that they can execute.

Barron: There is no question that having the infrastructure and the operational expertise as well as the actual securities can be an advantage to custody banks but, as Greg noted, every transition has its own dynamics and each one needs to be considered on its merits. However, once you burn one of our clients in a transition, it would be unlikely that we would ever consider you again.

Mollahan: That works in favor of institutions like us—we simply can't afford to violate the trust of our clients, and our relationship with that client is always bigger than any single product set.

PS: Institutional investors, as we all know, are investing increasingly in alternative assets. The custody banks long ago mastered the complexities of long-only portfolios: How well do they service their clients in the alternative space?

Barron: We've come a long way, but there is further work to be done before we accept custodial data in the nontraditional space as readily as we do their information for traditional investment classes. As a consultant, we still think a substantial amount of hands-on validation for this type of information is still necessary.

> **The net of all this is that, even though we've seen tremendous consolidation among custodians in the past few years, we're likely to see more**

Petrino: I agree, and I think, when it comes to hedge funds in particular, that custodians face real problems because of the lag in reporting—it's as if they are doomed to be always a month behind. Performance reporting always will be out of sync when it comes to hedge funds. I think there has been more progress made when it comes to private equity, however.

Korte: Clearly, the lack of transparency of hedge funds is not helpful, and it might take a major incident of some type to highlight the need for greater transparency. A lot of institutional money is moving into these alternatives and the reporting and performance measurements have to be improved.

Abesamis: I would agree that the industry is moving in the right direction. If you look at the acquisitions that the very large custodians have made in the hedge fund accounting space, it shows they understand the need to present this type of information more accurately and timely than it is today. It's another indication that the biggest and best custodians are connecting all the pipes together, and that's going to work to the advantage of plan sponsors.

Mollahan: This trend toward nontraditional investments is one we believe we identified ahead of our peers and, if you look at our technology spend over the last few years, we have increasingly been willing to invest in our capabilities to support our clients' investment in hedge funds, private equity, real estate, and derivatives. We know, and have acted on the belief, that it is never enough to support 95% of our clients' portfolios—we have to address every single investment choice our clients make. It's not just a technology decision on our part—it is key that you complement that spend with dedicated staff and resources that understand those asset classes and have the insights to be able to deal with them. We think this has set JPMorgan Investor Services apart from its peers, and we'd like to think that the investment trends now evident in the overall movement to nontraditional investment have justified our decision some years ago to truly concentrate on these asset classes.

For more information:
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